Alternative Investments – From Financial Statements to Tax Filings – Hot Spots and Pitfalls

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Agenda

• Alternative Investments Defined
• Financial Statements
  - What Does an Investor Need to Know?
  - Common Pitfalls in Investee Reporting
• Tax Reporting
  - Unrelated Business Income Implications
  - Federal and State Filing Requirements
  - Legislative Developments
  - Suggested Best Practices
Alternative Investments Defined
**What are Alternative Investments?**

- Outside the traditional cash, stocks, bonds investment realm
- Often not as regulated
- Lack of liquidity
- High minimum contribution
- Goal - diversify investor’s portfolio
Examples of Alternative Investments

- Investments
  - Options
  - Swaps
  - Futures
- Investment Structures
  - Hedge funds
  - Private equity funds
  - Venture capital funds
  - Real Estate
  - Commodities
  - REITs
Financial Statements – What Does an Investor Need to Know?
Why does an Investor Entity Need to Review an Investee’s Financial Statements?

• Fundamental component of demonstrating that an investor’s ongoing due diligence programs are operating effectively
  - Can be indicative of a sound internal control environment for an investor

• Provides insight into an investee’s financial reporting capabilities/sophistication

• Audited financial statements provide an investor an ability to corroborate key messages communicated during on-site and other diligence programs

• Provides basis of benchmarking from one investee to another
What are the Key Components of an Investee’s Financial Statements?

- Statement of Assets & Liabilities, including the Portfolio of Investments*
- Statement of Operations
- Statement of Cash Flows
- Statement of Changes*
- Footnotes to the Financial Statements, including the Financial Highlights*
- Supplemental Schedules
What are the Key Elements of an Investee’s Statement of Assets & Liabilities, including the Investment Portfolio?

- Statement of Assets & Liabilities
  - Liquidity and leverage operating within institutional mandate?

- Portfolio of Investments
  - Only required to show those investments that exceed 5% of net assets
  - Consistency with institutional mandate related to strategy and investment type?
  - May provide basis for aggregating known exposures, and provide comparison of fair valuation measurements within reasonable ranges
**What are the Key Elements of an Investee’s Statement of Changes?**

- **Statement of Changes in Partner’s Capital or Net Assets**
  - Often shown in the aggregate, unless supplemental schedules are provided
  - Are net assets shown net of accrued carried interest or other performance based charges?
  - What are contribution, distribution and/or withdrawal activities?
  - Do allocations between affiliated and unaffiliated entities reflect rights/obligations specified in contracts or offering documents?
What are the Key Elements of an Investee’s Footnotes to the Financial Statements?

- Fair valuation measurements, policies and leveling considerations, including some transparency into the range of significant unobservable inputs
- Allocation methodologies
- Redemptions features
- Financial Highlights related to total return, internal rate of return & expense ratios
- Disclosure of details related to uncertain tax positions
Common Pitfalls in Investee Financial Reporting
Common Pitfalls in Investee Reporting

- Advisors registered with the SEC are subject to Investment Advisors Act of 1940

- Beyond a series of initial and ongoing compliance requirements, investment advisors who meet the specified criteria may also be subject to an examination by the SEC

- Several observations arising from these examinations specific to the financial statements include:
  - Disclosure of fair valuation measurements and policies are not deep enough
  - Fair value leveling considerations are not sufficiently disclosed, including additional requirements to disclose weighted average calculations where there is divergence in the range of significant unobservable inputs
  - Disclosures related to related party transactions do not contain sufficient level of completeness
Tax - Unrelated Business Income Implications
UBTI implications in alternative investments

- Alternative investments are commonly organized as partnerships or LLCs with income passing through to partners/investors for tax purposes.
- UBTI from partnerships is derived generally from activities unrelated to the tax-exempt partners’ exempt purposes and income from transactions involving debt.
  - Examples include: hotel operations, working interest in oil & gas wells, leveraged investment strategy.
  - Look through the partnership to determine UBTI.
- Use of corporations may “block” UBTI. (See Appendix for detail.)
- UBTI impacts ROI.
UBTI arising from partnership activities

- UBTI reported on Schedule K-1 in Box 20, Code V. Most times details will be in K-1 footnotes. University may need to follow up with the partnership for additional information and/or confirmations.
- Watch out for other flow-through tax attributes (e.g., business tax credits, charitable contributions, AMT, federal and state withholding).
- Special attention must be paid to oil and gas partnerships as unique deduction opportunities are available (depletion and intangible drilling costs).
**Debt-financed property - “Exception to the exemption”**

- In the case of income earned from property which is debt-financed, the general exemptions from UBTI for passive investment income do not apply. See IRC section 514.
  - Property must be subject to “acquisition indebtedness.”
  - The percentage of income from debt financed property that is taxed is equal to the ratio of:
    \[
    \frac{\text{Avg. Acquisition Indebtedness}}{\text{Avg. Adjusted Basis of the Property}}
    \]

- Generally, partnerships will do this calculation for you and report your percentage or dollar of debt-financed UBTI.
Special rule for debt-financed real property

- Only for “qualified organizations,” a special rule exists that effectively allows you to set aside most debt-financed *real* property for purposes of UBTI. See IRC section 514(c)(9).
- Colleges & universities are “qualified organizations.”
- Real property investments through partnerships can apply the special rule to tax-exempt partners if certain criteria are met – commonly referred to as the “fractions rule.”
  - Watch for this when entering into real estate investments through partnerships.
  - Watch for this on Schedule K-1s when calculating UBTI.
Tax - Federal and State Filing Requirements
Federal filing requirements

- Forms 990, 990-T
- U.S. foreign information returns
  - Form 926 (Foreign corporation)
  - Form 8865 (Foreign partnership)
  - Form 5471 (Controlled foreign corporation)
  - Form 8621 (Passive foreign investment company)
  - Form 8858 (Foreign disregarded entity)
  - TD F 90-22.1 (Foreign bank account report, "FBAR")
    - Significant penalty for failure to file these forms
- Form 8886 (Reportable transactions)
**U.S. foreign filing requirements**

- What to report?
  - Certain direct and indirect transfers to and certain holdings in foreign partnerships reported on Form 8865
  - Certain direct and indirect transfers to and certain holdings in foreign corporations reported on Forms 926 and 5471
  - Certain holdings in passive foreign investment companies reported on Form 8621
  - Certain holdings in foreign disregarded entities reported on Form 8858
  - Certain financial interests or signature authority over financial accounts in a foreign country reported on TD F 90-22.1

(See Appendix for detail.)
**U.S. foreign filing requirements**

- Managing the process
  - Evaluate ownership interests and amounts transferred.
    - Direct ownership
      - Identify foreign partnership and corporation investments.
      - Annually track transfers to foreign partnerships and corporations.
    - Indirect ownership
      - Review Schedules K-1.
      - Exercise due diligence – inquire.
U.S. foreign filing requirement considerations

- Consider if the organization’s investment will expose it to potential filings and withholdings in foreign jurisdictions.

- Current activity by the Internal Revenue Service focuses on implementation of the Foreign Account Tax Compliance Act (FATCA).
  - FATCA was enacted to keep US persons from hiding income and assets overseas.
  - Failure to comply with the due diligence and registration requirements of FATCA can result in 30% withholding on certain payments, impacting ROI.
  - Organizations should review offering documentation and regularly conduct confirmations/due diligence to determine investment manager’s approach to the above issues.
State income tax complexities

• Nexus – what is it?
  - Minimum connections with a jurisdiction required for taxation

• What creates nexus?
  - Physical presence
  - Taking advantage of the business environment
  - Registration with the state

• Investment Activities
  - Partnership activities may create state income tax nexus and tax liability for its partners, including tax-exempt investors.
  - Number of states and localities that tax UBTI has grown – over 40 jurisdictions currently.
State income tax considerations

- States have adopted more aggressive nexus approaches.
- Allocation versus apportionment
- Searching for revenue, some states have suspended NOL deductions.
- Penalties for non-filers
- Increased state enforcement (also possibility of amnesty)
- Filing to preserve losses
- Partnerships may withhold tax.
State income tax processes

- Initially calculate UBI and identify where earned.
- Review federal and state K-1s for allocation and apportionment and withholdings.
- Assess need to file tax returns, extensions, estimated payments.
- Some states require business registration and/or have additional reporting requirements.
Tax - Legislative Developments
Heightened scrutiny

- Legislative proposals directed at use of offshore “blocker” entities and 2007 Congressional testimony.
- 2007 proposed legislation to modify debt-financed rules with respect to offshore “blockers.”
- Multiple legislative proposals to tax “carried interest” as ordinary income.
- IRS established an examination group which is auditing hedge and private equity funds.
- Reviewed by the IRS as part of the recent College & University exam project.
Heightened scrutiny

• IRS designation of withholding tax as a Tier I audit issue is resulting in more compliance activity.

• Increased cooperation between US and international tax authorities. The rise of audit activity is not limited to the US. Abroad, audits are focused on permanent establishment, beneficial ownership and residency issues.

• Taxing authorities around the world are becoming increasingly sophisticated, and, in some cases, increasingly aggressive in their quest to raise revenue in a softened economic environment.
Suggested Best Practices
**Monitoring alternative investments within your organization**

- Identify universe of alternative investments.
- Identify those investments which pass through UBTI and additional filing requirements (partnerships, LLCs, etc.).
- Develop a method to track Schedule K-1s.
  - K-1 UBI workbook
  - Questionnaire
  - Partnership/K-1 checklist
  - State allocation/apportionment
- Identify direct transfers to foreign corporations/partnerships.
- Follow up with investment managers is often necessary.
Tax - Appendix
UBTI implications in alternative investments

- Treas. Reg. §1.512(c)-1 - In the event an organization to which IRC §511 applies is a member of a partnership regularly engaged in an unrelated trade or business with respect to such organization, the organization shall include in computing UBTI its share (whether or not distributed) of the partnership’s gross income derived from that unrelated business and its share of the deductions attributable
**Alternative investments - blocker corporations**

- Use of corporations may "block" UBTI.
  - Tax-exempt investor can hold 100% of the stock in a foreign corporation that invests in a U.S. partnership holding debt-financed securities (PLR 9952086).
    - Dividends paid by the foreign corporation to the tax-exempt shareholder were excluded from UBTI and were not treated as debt-financed income – effectively “blocking” the UBTI.
    - Tax-exempt did not incur debt to acquire the foreign corp.
  - Tax efficient to create blocker corporation in a country that does not impose an income tax (i.e., Cayman Islands)
  - Important that blocker corporation is not taxable in the U.S. If it has effectively connected income, corporation will be taxable in the U.S. and use of blocker may lower ROI.
Structuring Alternative Investments to avoid UBTI

“Blocker” Transactions

Activity of CORP should not be attributed to University (provided CORP maintains separate identity) – CORP serving as a “Blocker”

Net income of CORP taxed at the Corporate level

UBI Issues

• Dividends generally excludable to the University
• Application of the “control rules” (more than 50% ownership)
• If CORP is an S-Corp, all income to University will be UBI
Federal filing requirements

- Form 990-T – Income / loss limitations
  - Capital losses generally limited to capital gains in any one tax year
- Form 990-T - Deductions / credits
  - Deductions related to the activity are allowed; limitations apply to certain deductions
    - Deduction for investment interest expense limited to net investment income
    - Separate charitable contributions (limited to 10% of total net income for corporations)
- Exempt organizations are permitted to claim business tax credits including foreign tax credit if connected to UBI
U.S. foreign filing requirements

Transfers to Foreign Corporations (Form 926)

• A U.S. person that transfers cash or property to a foreign corporation and after the transfer, the transferor directly (or indirectly) owns 10% or more of the foreign corporation,
  - or

• If the cash transferred by the person during the 12-month period ending on the date of the transfer exceeds $100,000
**U.S. foreign filing requirements**

**Transfers to Foreign Partnerships (Form 8865)**

- 4 Categories of Filers:
  - Category 3 Filers – U.S. person who contributed property to foreign partnership during person’s tax year who, after contribution:
    - Owned at least 10% in partnership, or
    - The value of property transferred (aggregated with other contributions of property in 12 months preceding date of transfer) exceeds $100,000
U.S. foreign filing requirements

Transfers to Foreign Partnerships (Form 8865) (cont.)

- Category 1 Filers – Where a U.S. person controlled greater than 50% of foreign partnership at any time during partnership’s tax year
- Category 2 Filers – Where two or more U.S. persons each own at least 10% of foreign partnership and collectively own greater than 50% at any time during partnership’s tax year
- Category 4 Filers – U.S. person that had a reportable event under Section 6046A (acquisitions, dispositions or changes in proportional interests)
**U.S. foreign filing requirements**

Information Return of U.S. Persons with Respect to Certain Foreign Corporations (Form 5471)

- 5 Categories of Filers:
  - Category 1 Filers – N/A
  - Category 2 Filers – Only applies to individuals
  - Category 3 Filers – have acquired stock in a foreign corporation so that interest totals at least 10% ownership in foreign corporation, or, has disposed of stock in foreign corporation so that interest is reduced to below 10%
**U.S. foreign filing requirements**

**Form 5471 – 5 Categories of Filers (cont.)**

- Category 4 Filers – Had 50% or more control for at least 30 consecutive days during the foreign corporation’s annual accounting period
- Category 5 Filers – Owned at least 10% stock in a controlled foreign corporation for at least 30 consecutive days, or any amount of stock of a controlled foreign corporation that was also a captive insurance company
U.S. foreign filing requirements

Return by a Shareholder of a Passive Foreign Investment Company or Qualified Election Fund (Form 8621)

- Must be filed every year in which a taxpayer is a direct or indirect shareholder of a PFIC
- PFIC is a foreign corporation in which ≥ 75% of its gross income is passive (dividends, interest, rents, capital gains)
- Treas. Regs. provide that PFIC rules only apply to shareholders that are exempt organizations if a dividend from the fund would be UBTI; pending guidance may expand this filing requirement.
U.S. foreign filing requirements

Report of Foreign Bank and Financial Accounts (Form TD F 90-22.1)

- Must be filed every year in which a taxpayer has a “financial interest” in or signatory authority over any “financial account” in a foreign country, if the aggregate value of these financial accounts exceeds $10,000 at any time during the calendar year
- “Financial accounts” include bank, securities, equity interests in commingled funds
- “Financial interest” includes direct ownership and direct and indirect ownership of > 50% if held by corporation, partnership or trust
**U.S. foreign filing requirements**

**Form TD F 90-22.1 (cont.)**

- Must be filed with the U.S. Department of the Treasury in Detroit, MI on or before June 30 of the following year

- Penalties
  - Civil and criminal penalties for failure to file
  - Proposed legislation would add additional civil penalties for failure to file without regard to wilfulness
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